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UNCLAS SECTION 01 OF 02 TEL AVIV 006763

SIPDIS

SENSITIVE

E.O. 12958: N/A
TAGS: ECON EFIN IS ECONOMY AND FINANCE
SUBJECT: Fischer Takes Command: BOI Rate Hike Counters Inflation Threat

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Summary

¶1. (SBU) In an expected move, the Bank of Israel (BOI) announced a 0.5 increase in interest rates on November 28, bringing the base rate to 4.5 percent. This was the Central Bank's third consecutive monthly hike, and the most pronounced, following increases of 0.25 percent at the end of both September and October. This sharper increase is the BOI's attempt to return inflation to the mid-point of the 1 to 3 percent GOI target range. Inflation for the first 10 months of 2005 was 2.7 percent, inching towards the upper limit of the range, with the November and December inflation figures yet to be reported. With this move, BOI Governor Stanley Fischer has demonstrated an intention to pursue an aggressive monetary policy to keep inflation in check. The CBS released third quarter unemployment figures, which indicated a decline to 8.9 percent from the second quarter's 9.1 percent. In addition, the rating agency Fitch confirmed its positive rating outlook for Israel and noted the economic achievements of the Sharon government. Finance Minister Olmert commented that responsible and balanced economic policies need to be maintained in order for rating agencies to upgrade their ratings of the Israeli economy. End Summary.

BOI Wants Price stability

¶2. (U) The BOI's November 28 press release explicitly states that its aim is to achieve price stability, which is defined as inflation of 1 - 3 percent. In the concluding paragraph, after listing the reasons for the interest rate increase, the press release states, "The Bank will continue to keep inflation under close and constant review, with the intention of reaching the government's target without deviating from it either upwards or downwards."

¶3. (SBU) Inflation rates during the Governorship of Stanley Fischer's predecessor, David Klein, from the beginning of 2000 to early 2005 were 0 percent in 2000, 1.4 percent in 2001, 6.5 percent in 2002, -1.9 percent in 2003, and 1.2 percent in 2004. These inflation figures should be viewed in the context of the Intifada and the ongoing aggravated security situation, negative growth, and the government's austere fiscal situation, all of which made monetary policy decisions more difficult than usual. By raising interest rates a full half point instead of just a quarter point, Fischer showed that he intends to pursue an aggressive monetary policy to keep inflation in check. The BOI's press release noted that it could take several months to return inflation to the mid-point of the target range.

The Rate Hike Supports the Shekel

¶4. (U) One of the major factors that led to the increase in inflation in the last few months has been the rapid rise in the dollar vis--vis the shekel. The average monthly dollar/shekel exchange rate increased from NIS 4.54 in September to NIS 4.63 in October. After trading in the NIS 4.70 to 4.74 range during the first half of November, market anticipation of another rate increase brought the dollar down to just under NIS 4.70 just before the increase was announced. The day after the announcement, the shekel appreciated against the dollar, and is now trading in the NIS 4.65 range.

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Maintaining Fiscal Discipline Despite Political Uncertainty
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¶5. (U) In its press release, the BOI alluded to the general political situation in Israel by noting that the rate was raised, in part, to counter the prevailing political uncertainty. The release also noted the BOI's expectation

that the GOI is likely to maintain fiscal discipline.

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Fitch Retains Strong Ratings for Israeli Economy
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¶6. (U) The Fitch rating agency, in a November 28 statement, retained its A minus rating for foreign and A rating for domestic debt, and noted that the Israeli economy remains stable, despite an atmosphere of uncertainty. Fitch expects the 2006 budget and policy framework to be similar to 2005, and maintained that the impact of the elections, "if any," will only become evident in the framework of the 2007 budget. The Fitch analyst noted, however, that "there is no room for complacency."

No Upgrade, but MOF Pleased with Fitch Report

¶7. (U) In its report, Fitch emphasized the important fiscal and structural reforms implemented by the Sharon government, which contributed significantly to stabilizing Israel's creditworthiness. Following the Fitch announcement, Finance Minister Ehud Olmert noted the GOI's restraint in fiscal policy and confirmed that the government would continue to make structural reforms, which he said would improve Israel's growth prospects. The Minister added that responsible and balanced economic policies need to be maintained in order for rating agencies to upgrade their ratings of the Israeli economy. In a public comment, Dr. Yaron Zelekha, the Accountant General, noted Fitch's assessment that a continued gradual decline in the public debt could bring about an eventual upgrade in the rating.

Unemployment Down

¶8. (U) In an additional piece of positive economic news, the Central Bureau of Statistics reported on November 28 that unemployment declined from 9.1 percent in the second quarter to 8.9 percent in the third quarter. This is the first time since 2001 that unemployment has been below 9%. The number of employed persons increased by 83,200 (3.5%) in the first 9 months of the year, compared with the comparable period in 2004. Average unemployment from January to September was 9.1 percent.

Labor Participation Rate Steady - and Too Low

¶9. (SBU) Unemployment rates may continue to marginally decline in the coming months as a result of a pool of jobs traditionally created in conjunction with elections. However, many of these jobs will be temporary and will not provide permanent relief to the chronically unemployed. In addition, the latest labor participation rate just released by the CBS for the third quarter remained at 55.2 percent, somewhat lower than the rates in other developed economies. Therefore, meaningfully reducing unemployment and increasing labor participation will remain critical challenges for the next Israeli government.

JONES